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Taking Care of Business: Use of a For-Profit Subsidiary by a Nonprofit Organization

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Taking Care of Business: Use of a For-Profit Subsidiary by a Nonprofit Organization

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Revenue generation continues to draw significant attention in the nonprofit sector. Rather than rely exclusively on donations, many nonprofits seek to become self-sustaining through earned income. While in some cases revenue may be generated by activities that clearly further the nonprofit's mission, other activities may be desirable primarily for the revenue they produce or involve other aspects that do not fit neatly within a nonprofit (or tax-exempt) framework. In these situations, legal and business factors may favor the creation of a for-profit entity to carry on the activity.

While any nonprofit organization might consider launching a subsidiary, this article focuses on public charities that are tax-exempt under Internal Revenue Code Section 501(c)(3). Private foundations and nonprofit organizations that fall under other categories of tax exemption, like trade associations or social welfare organizations, will encounter compliance requirements specific to their tax-exempt status.

Why Would a Charity Want to Create a For-Profit Subsidiary?

Expanding Activities Beyond Those That Are Clearly Charitable

Although charities and other nonprofit organizations generally are exempt from income tax, they can incur tax on their unrelated business income. The unrelated business income tax, or "UBIT," applies to income derived from a regularly carried on trade or businesses that is unrelated to the performance of the organization's tax-exempt (e.g., charitable) functions. This tax was introduced in 1950 as a means to prevent tax-exempt organizations from having an unfair advantage by virtue of their tax-exempt status over for-profit, taxable competitors when they engaged in commercial business activities.

An organization potentially can derive significant income from unrelated business activity and pay any UBIT incurred. At some point, however, the activity may become so substantial that it could threaten the tax-exempt status of the organization. In that case, the entity may be well-advised to move the activity into a separate legal entity, such as a subsidiary corporation. There is no bright-line for how much unrelated business activity is too much for a nonprofit to conduct; housing the activity in a corporate subsidiary can avoid concern about when this line has been crossed.

In addition, it is not always clear under federal tax law when an activity might be considered unrelated to the charity's tax-exempt purpose. For instance, operating a training program or publishing books, while educational, may too closely resemble a for-profit business to qualify as substantially related to a charitable purpose. An organization may focus on serving low-income or other underserved communities, or selling its product at a lower price only to other charities, in order to be comfortable that the activity is substantially related. However, a nonprofit organization with a successful business model may not want to limit the scope of its activities in this way. Instead, it may wish to increase revenue by offering its product or service at fair market value to the broadest audience possible. A for-profit subsidiary maximizes flexibility to pursue a wide range of profit-making activities and to take advantage of future opportunities as they arise.

Shielding the Parent from Liability

A nonprofit organization, especially one with a large endowment or other significant assets, may not want to risk those assets by operating a business with potential liabilities. In these circumstances, it may be prudent for the nonprofit parent to protect its other assets and activities by isolating the business in a limited-liability subsidiary. No social service organization, for instance, would want to see its programs for at-risk youth jeopardized if the day-care center that it also owns is sued.

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